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IN THE

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE NINTH CIRCUIT

STOCKGROWERS STATE BANK OF MOUNTAIN-HOME, a Corporation, and THE FIRST NATIONAL BANK OF MOUNTAINHOME, a Corposation, Appellants,

vs.

CHARLES E. CORKER, Trustee of the Estate of Thomas Trathen, a Bankrupt, Appellee.

APPELLANTS' BRIEF.

Upon Appeal from the United States District Court for the District of Idaho, Southern Division.

E. M. WOLFE,
WYMAN & WYMAN,
Appellants' Solicitors.

Statesman Shop, Boise, Idaho.

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STATEMENT OF THE CASE.

This action was brought by the appellee as trustee in bankruptcy to set aside not only a mortgage given by the bankrupt but also a foreclosure sale thereunder and to recover possession of the mortgaged property. We believe there is no serious dispute as to the facts.

Trathen, a furniture dealer in Mountain Home, Idaho, was adjudged a bankrupt on October 23rd, 1911. Some years prior to the time of the transaction here complained of, he had been a customer of the Stockgrowers State Bank of that city (p. 29) but, for some cause not shown in the record nor material to the decision of the case, had transferred his account to the First National Bank, also of Mountain Home, where he had transacted his

banking business for several years prior to the events out of which this case arose.

He was a borrower at the First National Bank probably from the beginning of his relations there and from time to time rendered that bank financial statements as bases for credit. These statements are to be found at pages 42, 49 and 50 of the transcript. They show his claimed assets to be well about the amount of his debts—in other words, if the statements were true, he was perfectly solvent. It was under these represntations and conditions that the First National Bank made its loans to Trathen and carried his account.

On April 12, 1909, he gave the bank a note for $1,700.00, due in three months, upon which W. D. Evans and John Owens were liable as sureties or guarantors. The latter, to secure themselves against loss upon their signatures, took a chattel mortgage on Trathen's stock of goods, which they caused to be placed on record as required by law. A copy of this mortgage is found at page 13 of the transcript.

This mortgage was afterwards assigned to the First National Bank, where it was thereafter held as security for Trathen's obligation (p. 38-39). In addition to this, the bank held Trathen's unsecured note for $500.00 (p. 30).

This was the situation on July 13, 1911, when Trathen applied to the First National Bank for a further loan. Mr. Chattin, president and a director of the bank, favored the loan and went so far as to instruct the bank's attorney to prepare the notes and mortgage, which were to include the Trathen debt at that bank and some claims Mr. Wolfe had (p. 47). Mr. Montgomery, also a director

and the assistant cashier, was likewise perfectly willing to make the loan (p. 53).

The cashier, Mr. Austin, was dissatisfied with the account (p. 32) and refused to extend the accommodation (p. 31). The matter was carried to the board of directors for final decision.

Trathen was called before the board and his financial condition was discussed. He represented that business was dull but that, if he could borrow enough to take up the accounts Mr. Wolfe held, he would himself be able to take up others; and that Mr. Wolfe's accounts were the only ones pressing him. Despite the fact the president and assistant cashier desired to make the additional loan, the cashier's position "was supported by the directors" (p 31), and the additional loan was declined and it was made plain to Trathen that the situation was unsatisfactory to the bank.

The First National Bank at the time had *R. P. Chattin* as President, F. E. Austin as Cashier, and these men, together with *Montgomery,* Hein, Pence and Blunk constituted its Board of Directors (p. 30). The officers of the Stockgrowers State Bank then were F. P. Ake, President; Worth S. Lee, Cashier, who with *Chattin, Montgomery,* Hall, Cowen and Blackman formed its board of directors (p. 29). Chattin and Montgomery were directors in both institutions and it was these men who were the particular friends of Trathen and who sought to have the First National Bank continue to carry him. Failing in this, these directors went to the Stockgrowers Bank where, as we have seen, Trathen had at one time banked and they induced it to take over the Trathen account.

The record shows but very meagerly what took place at the latter bank. Chattin was very instrumental in

getting the loan (p. 54) and there would seem to be no question but that it was through his and Montgomery's efforts the latter bank was induced to agree to loan Trathen the money he needed to take up the debt due the First National Bank as well as to Mr. Wolfe's clients.

The note and mortgage were executed and the latter recorded on the 13th day of July, 1911 (p. 52), and the amount due the First National Bank was paid to it.

At about the same time as the matters heretofore related, the Stockgrowers Bank called a loan it had made a Mr. Herder of the Mountain Home Furniture Company and he paid that bank through a loan secured from the First National Bank (p. 32). This loan was obtained largely through the efforts of Chattin and Montgomery, through Roscoe Smith, an officer in the Stockgrowers Bank, took some part in the negotiations (p. 32-33). Considerable was attempted to be made of this transaction by appellee in the court below. It must not be forgotten that the Herder loan was a perfectly good one (p. 30-33). The net result to the Stockgrowers Bank of the two transactions was that it paid the First National Bank $2,294.35 and agreed to pay Mr. Wolfe $853.49, making a total of $3,147.84 (p. 29) and it received from the First National Bank about $3,606.69 (p. 30). So it received $1,312.34 more than it paid out.

Before actually paying Mr. Wolfe the amount due his clients, the Stockgrowers Bank ascertained that the stock on which it had a mortgage was not entirely satisfactory. The bank supposed it was getting a lien on property it subsequently found was not included in its mortgage (p. 35). In accordingly refused to pay the money due to Mr. Wolfe (p. 35). Mr. Trathen begun neglecting his business, allowing his store to remain closed for days at a

time (p. 56); he failed to comply with the conditions of the mortgage; the bank became dissatisfied with the situation and began foreclosure proceedings (p. 56). The Sheriff, on the 2nd day of October, 1911, sold the property on foreclosure to the Stockgrowers Bank for $2,465.18 (p. 45).

On October 23, 1911, Trathen was adjudged a bankrupt, and on December 19th, 1911, Corker, the Trustee, demanded possession of the goods from the Stockgrowers Bank, but, though informed that the bank was in possession under claim of ownership and waiting for some one to contest its claim, the trustee did nothing further until August 8, 1913, considerably over a year and a half, when he commenced this action. During all this time he Stockgrowers Bank held the property intact awaiting some action on the part of the trustee. The defendants promptly answered and the cause came on for trial on October 8th, 1913. The Court below held the mortgage to the Stockholders Bank to be null and void, that the First National Bank secured thereby a greater percentage of its debt than other creditors of the same class; that the sale on foreclosure was also null and void, and it decreed that the plaintiff recover the stock of furniture, notes and accounts and that, should the defendants not deliver the property to plaintiff within twenty days after the filing of the decree, plaintiff have execution against them for $2,465.18, the value of the furniture, with interest from November 18, 1911, and costs of suit.

SPECIFICATION OF ERRORS.

1st. The District Court erred in holding and concluding that the said Thomas Trathen was insolvent on the 13th day of July, 1911.

2nd. The District Court erred in holding and concluding that the officers and directors or officers or directors or both or either of the defendants, knew on the 13th day of July, 1911, or at any other time or at all, that Thomas Trathen was insolvent and unable to meet his obligations or was insolvent or unable to meet his obligation.

3rd. The District Court erred in holding and concluding that the officers and directors or officers or directors or both or either of these defendants, conclusively or fraudulently or for any purpose or at all planned and agreed with each other and with said Trathen or at all that the amount of the same Trathen loan should be ostensibly or at all transferred from the said First National Bank to said Stockgrowers State Bank and that said Stockgrowers Bank should make a pretended or any loan to said Trathen or should secure from him any chattel mortgage whatsoever.

4th. The District Court erred in holding and concluding that in accordance with any such or any other agreement said Trathen did without consideration execute and deliver said note to said or any Stockgrowers State Bank, or that he gave the said mortgage to said Stockgrowers State Bank in accordance with any such or any agreement or understanding between said defendants.

5th. The District Court erred in holding and concluding that the foreclosure and sale under said chattel mortgage was other than a bona fide transaction and proceeding for the enforcement of a valid chattel mortgage.

6th. The District Court erred in holding and concluding and decreeing that this or any part of said stock of furniture, notes and accounts constituted a part of the assets of said Trathen at the time he was adjudicated a bankrupt.

7th. The District Court erred in holding and concluding that the defendant First National Bank has ever had said furniture, notes or accounts in its possession.

8th. The District Court erred in holding, concluding and decreeing that the matters set forth in plaintiff's Bill of Complaint or shown by the evidence operated as a preference or to secure a preference for either of these defendants.

9th. The said District Court erred in holding, concluding and decreeing that either of these defendants or their or either of their agents had reasonable or any cause to believe that the execution of the said note and mortgage or either of them would effect any preference whatsoever.

10th. The District Court erred in holding, concluding and decreeing that the transfer and mortgage or transfers or mortgage made and executed by said Trathen to said Stockgrowers Bank was null and void as against the rights of other creditors of said Trathen or at all.

11th. The District Court erred in holding, concluding and decreeing that the said First National Bank by said transfer obtained a greater percentage of its debt against Trathen than other creditors of the said class.

12th. The District Court erred in holding, concluding and decreeing that the said sale by the sheriff of Elmore County was and is or was or is null and void.

13th. The District Court erred in holding, concluding and decreeing that plaintiff should have or recover of and from said defendants or of or from either of them the said furniture described in said decree or any part thereof, or of said notes or accounts in said decree referred to.

14th. The District Court erred in holding, concluding and decreeing that if defendants do not deliver said property to plaintiff in 30 days or at all from and after

the filing of said decree that plaintiff have execution against said defendants or against either of them for any sum whatsoever.

15th. The District Court erred in holding, concluding and decreeing that plaintiff have interest on the sum decreed plaintiff from the 18th day of November, 1911, or from any other time or at all.

16th. The District Court erred in holding, concluding and decreeing that the said defendant Stockgrowers State Bank was not entitled to the benefit of and did not hold a first lien upon the said stock of furniture superior in all respects to and not subject to the claims of the said plaintiff herein and of all other creditors of said Trathen.

17th. The District Court erred in holding, concluding and decreeing that the defendant Stockgrowers State Bank was entitled to no relief by reason of the matters set forth in the VII paragraph of the answer of said defendant.

CORRECTION OF RECORD.

We regret the necessity of calling attention to an error in the record. By some inadvertance occurring in the type written statement of the case, a page seems to have been so transposed that pages 51 and 52 of the printed record should follow the fifth line on page 29. This correction is made by stipulation of the parties filed herein.

ARGUMENT.

While we have included in our specification of errors practically all those heretofore assigned, it is apparent the discussion may be considerably narrowed. We think the record presents primarily the question whether at the time the Trathen loan was made appellants believed or has

reasonable ground to believe that Trathen was insolvent. The circumstances of the giving of that mortgage and of the relationship between the banks are important only as they throw light upon that question.

It is unnecessary to restate the evidence. The record is short and such differences of opinion as there may be upon its reading arise more as to the inferences properly to be drawn and conclusions reached from the facts than as to what are the facts themselves.

When Trathen, in 1909, obtained his loan of $1,700.00 from the First National Bank, he gave that bank the security of two other signers, Evans and Owens. They secured themselves against loss by a mortgage on his stock of goods. While it is true this mortgage was afterwards assigned by them to the bank that it might be more directly secured, such action was unnecessary. The security so held by the sureties enured to the benefit of the bank without such assignment.

Hampton vs. Phipps 108 U. S. 260.

Courier-Journal T. P. Co. vs. Shaefer M. B. Co. 101 Fed. 699.

Swift & Co. vs. Kortrecht, 112 Fed. 713.

The wide application of this rule is shown in 32 Cyc. 145 to 149. The assignment of the mortgage by the sureties to the First National Bank, while unnecessary, was perfectly valid.

32 Cyc. 148.

So the First National Bank had, at the time of this transaction, a mortgage on the merchandise in question securing Trathen's note of $1,700.00, and, as it had been of record for more than four months, it was absolutely unassailable under the Bankruptcy Act. The First Na-

tional Bank's position was therefore secure as to the greater part of Trathen's debt. It had no occasion to change that position. The debt was due and it could at any moment take possession of the stock. It is of the utmost importance to a correct understanding of the situation to realize the strength of the position of the First National Bank at that time and to view its subsequent action and to judge of its motives from that standpoint.

But Trathen needed more money. This involved a new risk and a readjustment of the security. This the First National Bank refused to do. Application was made to the Stockgrowers Bank, the loan secured and the First National Bank was paid. The only ground on which the decree can be sustained is that in this matter the banks knew or had reasonable ground to believe Trathen was insolvent, and that, therefore, the mortgage to the Stockgrowers Bank constituted a voidable preference.

This involves the application of Section 60-b of the Bankruptcy Act as amended by the Act of June 25, 1910. It is as follows:

> "If a bankrupt shall have procured or suffered a judgment to be entered against him in favor of any person or have made a transfer of any of his property, and if, at the time of the transfer, or of the entry of the judgment or of the recording or registering of the transfer if by law recording or registering thereof is required, and being within four months before the filing of the petition in bankruptcy or after the filing thereof and before the adjudication, the bankrupt be insolvent and the judgment or transfer then operate as a preference, and the person receiving it or to be benefited thereby or his agent acting therein shall then have reasonable cause to believe that the enforcement of such judgment or transfer would effect a preference, it shall be voidable by the trustee and he may recover the property or its value for such person. And for the pupose of such recovery any court of bankruptcy as hereinbefore defined and any state

court which would have had jurisdiction if bankruptcy had not intervened shall have concurrent jurisdiction."

In considering the matter, however, it is not just to view the question in the light of subsequent events. As was said in the Lorch case, hereinafter cited, "it would be unfair to charge the Fixture Company with knowing then what all of us know now." Trathen was undoubtedly badly involved at the time of giving the Stockgrowers' Bank mortgage; he was probably insolvent; we can all see that now; *did the banks know or have reasonable cause to believe it then?*

The facts are fully before the Court, and the rule of law with respect to what constitutes knowledge of insolvency or a reasonable cause for such a belief is of course familiar to your Honors, but we wish to call attention briefly to certain cases that state the rule either authoritively or distinctly. In the case of Sam Z. Lorch & Co. 199 Fed. 944, the Court said:

> "As we construe these provisions, a transfer by way of mortgage made by a bankrupt is 'voidable by the trustee,' providing the following facts concur, namely: First, if the transfer is made within four months before the filing of the petition; Second, if the bankrupt is insolvent when the transfer is made; Third, if the effect of the enforcement of the transfer will make any one of the bankrupt's creditors to obtain a greater percentage on his debt than any other creditor of the same class; and fourth, if at the time of the making of the transfer or if at the time it was recorded, the person receiving it, or his agent acting therein had at either of those times reasonable cause to believe the enforcement of the transfer would effect a 'preference'—that is to say that its enforcement would give him a larger percentage on his debt than other creditors would receive. As no greater percentage could be recovered under the transfer if the debtor be solvent and all his debts be paid in full, a creditor cannot be said to have reasonable cause to believe the enforcement of the transfer would effect

a preference unless either at the time the transfer was made or at the time it was recorded he had reasonable cause to believe that his debtor was then insolvent."

The leading case is that of Grant vs. National Bank, 97 U. S. 80, where the Court, through Mr. Justice Bradley, said:

"Some confusion exists in the cases as to the meaning of the phrase 'having reasonable cause to believe such a person is insolvent.' Dicta are not wanting which assume that it has the same meaning as if it had read 'having reasonable cause to suspect such a person is insolvent.' But the two phrases are distinct in meaning and effect. It is not enough that a creditor has some cause to suspect the insolvency of his debtor, but he must have such a knowledge of facts as to induce a reasonable belief of his debtor's insolvency in order to invalidate a security taken for his debt. To make mere suspicion a ground of nullity in such a case would render the business transactions of the community altogether too insecure. It was never the intention of the framers of the Act to establish any such rule. A man may have many grounds of suspicion that his debtor is in failing circumstances and yet have no cause for a well grounded belief of the fact. He may be unwilling to trust him further, he may feel anxious about his claim and have a strong desire to secure it, and yet such belief as the Act requires may be wanting. Obtaining additional security or receiving payment of a debt, under such circumstances is not prohibited by the law. Receiving payment is put in the same category, in the section referred to, as receiving security. Hundreds of men constantly continue to make payments up to the very eve of their failure, which it would be very unjust and disastrous to set aside. And yet this could be done in a large proportion of cases if mere grounds of suspicion of their solvency were sufficient for the purpose.

"The debtor is often buoyed up by the hope of being able to get through with his difficulties long after his case is in fact desperate, and his creditors, if they know anything of his embarrassments, either participate in the same feeling or at least are willing to think that there is a possibility of his succeeding.

> To overhaul and set aside all his transactions with his creditors made under such circumstances, because there may exist some grounds of suspicion of his inability to carry himself through would make the Bankrupt Law an engine of oppression and injustice. It would in fact have the effect of producing bankruptcy in many cases where it might otherwise be avoided."

In Stucky vs. Masonic Savings Bank, 108 U. S. 74, in referring to the Grant case, Mr. Justice Miller, speaking for the Court, said:

> "The whole matter turns upon the question whether, Krieger who acted almost alone for the bank had reasonable ground to believe that Melter was insolvent at the time the mortgages were made. The District Judge who decided that he had such reasonable ground, does not seem to have given due weight to the principles of the case of Grant vs National Bank decided by this court, and reported in 97 U. S. 80, a case which was fully considered and which has since been followed by us as a leading one on the subject.
>
> "That case establishes the doctrine that a creditor dealing with a debtor whom he may suspect to be in failing circumstances, but of which he has no sufficient evidence may receive payment or security without violating the bankrupt law."

And see

> Powell vs. Gate City Bank, 178 Fed. 609.
>
> In re. Eggert, 98 Fed. 843.
>
> In re. Pfaffinger, 154 Fed. 523.

We think the case at bar falls within the rule laid down by these cases and that the evidence shows the officers of both banks believed at the time the Stockgrowers Bank's mortgage was taken that Trathen would be able to "pull through" if helped over a temporary difficulty.

The burden is admittedly upon the trustee here to prove that the banks had reasonable cause to believe Trathen to

be insolvent and having, as we believe, failed to make that proof, no decree could properly be rendered against either defendant.

II.

If your Honors take the view that the First National Bank for some reason wished to make its position more secure and to that end made some undisclosed arrangement with the Stockgrowers Bank whereby the latter made the Trathen loan but really for the other bank, then the situation is this:

The First National is indeed chargeable with the acts of the Stockgrowers Bank and the mortgage taken by that bank would in reality become that of the First National. Thus the First National Bank would not have changed its position through the transaction. Its new mortgage would be a renewal of its old one. But such a renewal is not within the Bankruptcy Act.

The rule is analogous to that relating to an exchange of securities with respect to which, in Sawyer vs. Turpin, 91 U. S. 114, the Court said:

> "It is too well settled to require discussion, that an exchange of securities within the four months is not a fraudulent preference within the meaning of the bankrupt law, even when the creditor and the debtor know that the latter is insolvent, if the security given up is a valid one when the exchange is made, and if it be undoubtedly of equal value with the security substituted for it."
>
> Stewart vs. Platt, 101 U. S. 731.

And see in re. Reese-Hammond R. B. Co. 181 Fed. 641.

If it be urged that the Stockgrowers Bank's mortgage secures a larger debt than the older mortgage did, it is replied that this would affect the excess only.

The First National Bank had a mortgage for $1,700.00

and it received from the Stockgrowers Bank $2,294.35. The excess is therefore $594.36, while the decree against the First National Bank is for $2,465.18, exclusive of interest and costs, a sum nearly two hundred dollars more than the amount it is claimed it received as a preferential payment.

Again, it may be urged that the later mortgage covers some property not included in the first. Doubtless this is true, though it does by no means clearly appear so from the evidence. But the burden was on the trustee to show such facts as would warrant the Court in setting aside the Stockgrowers Bank's mortgage. The testimony of his own witnesses while testifying in his behalf had shown all the facts and circumstances: that the First National Bank held a mortgage on the stock and that the new mortgage was taken on practically the same stock, securing, so far as Trathen was concerned practically the same debt. If the latter mortgage was voidable as to any part of the debt or as to any part of the stock, the burden was on the trustee to show what part that the Court might do justice as among the parties before it.

III.

It was claimed by counsel in the court below that the mortgage to the ~~Stockgrowers~~ First National Bank was void. Such is not the law nor did the Court below so rule. It is true the mortgage contained no provision for the application of the proceeds of the sales of the mortgaged property upon the debt; but it is also true that the bank took possession of the mortgaged property some time prior to the filing of the petition in bankruptcy. This, under the Idaho decisions, cured any such defect.

Ryan vs. Rogers, 14 Ida. 309.

Dittemore vs. Cable Milling Co. 16 Ida. 298.
Martin vs. Holloway, 16 Ida. 513.

If it be contended that such possession must be taken with the consent of the mortgagor and not in hostility to him and that here the property was seized by the sheriff, it is replied that there is abundant evidence to show that this was done with Trathen's acquiesence rather than otherwise (p. 55). The rule so contended for would doubtless be correct if the mortgage were void as between the parties; then the mortgagee's lien would indeed depend wholly upon his possession secured with the consent of the mortgagor. But where the mortgage is good as between the parties and is void only as to attaching creditors and the like, the necessity for possession on the part of the mortgagee exists only where it is sought to cut off claims about to be made liens upon the property. Possession is not required as against general creditors.

It is true the filing of the petition in bankruptcy upon which an adjudiciation follows gives, for some purposes, the same rights as an attachment lien, but here the petition was not filed until the property was already in the sheriff's possession. Trathen himself testified that at the time or shortly before the foreclosure proceedings he urged the bank to take possession.

The entire question would seem to be set at rest by the decisions of the Supreme Court of Idaho in the cases cited above.

IV.

It must not be overlooked that the net result of the entire transaction was to leave the debtor's estate in practically the same condition as prior thereto. There had been prac-

tically no diminution of his estate. There was therefore no voidable preference.

National Bank of Newport vs. National H. C. Bank, 225 U. S. 178.

New York C. N. Bank vs Massey, 192 U. S. 138.

Nor must it be forgotten that there is involved in this case no element of fraud. The defendants had a perfect right to take security for the debt due from Trathen. Even had they known he was insolvent at the time, still there was no actual fraud. (Coder vs. Arts, 213 U. S. 223.) The mortgage was good, unless bankruptcy supervened and the transfer was avoided at the suit of the trustee.

We ask that the decree be reversed.

Respectfully submitted,

E. M. WOLFE,

WYMAN & WYMAN,

Appellants' Solicitors.